6. FISCAL POLICY

New Zealand faces a deteriorating fiscal situation. Unless corrected, this will have serious consequences for the whole economy.

If no changes to current policies occur, the financial deficit is likely to rise to $3.7 billion in 1991/92, grow again to $4.5 billion in 1992/93, and rise further to $5.2 billion in 1993/94. Associated with these deficits would be a sharp rise in public debt.

Deficits of this size would damage prospects for growth and incomes. They create an ever-increasing risk that investors will lose confidence in New Zealand. Interest rates could rise and the exchange rate could fall very sharply. Cutting the deficit would involve short-run costs for the many groups within the economy. But a more balanced Budget is essential for future economic growth.

The root cause of our persistent fiscal problem is that expenditure continues to rise steadily as a proportion of GDP. The more government spending can be held in check and the pressures on our tax system reduced, the more our economic performance will improve.

INTRODUCTION

Several key messages emerge from the chapter. The fiscal outlook has deteriorated and needs urgent attention. Significant reductions in the financial deficit are required in the short term in order to provide better policy balance, lessen exposure to ongoing fiscal risk through debt build up, and create greater investor confidence about future tax burdens. Reductions in government expenditure should be the primary means of reducing the deficit. Moreover, the fiscal problem will only be permanently resolved if the Government commits itself to a clear strategy which recognises the importance of fiscal discipline and ensures expenditure is targeted at high-priority areas.

FISCAL POSITION

Fiscal Outlook

The fiscal outlook is summarised in Table 6A below which shows projections for the financial and Budget Table 2 balances. The Budget Table 2 balance represents the difference between the total cash expenditure and revenue of the Government.

TABLE 6A - CURRENT FISCAL OUTLOOK

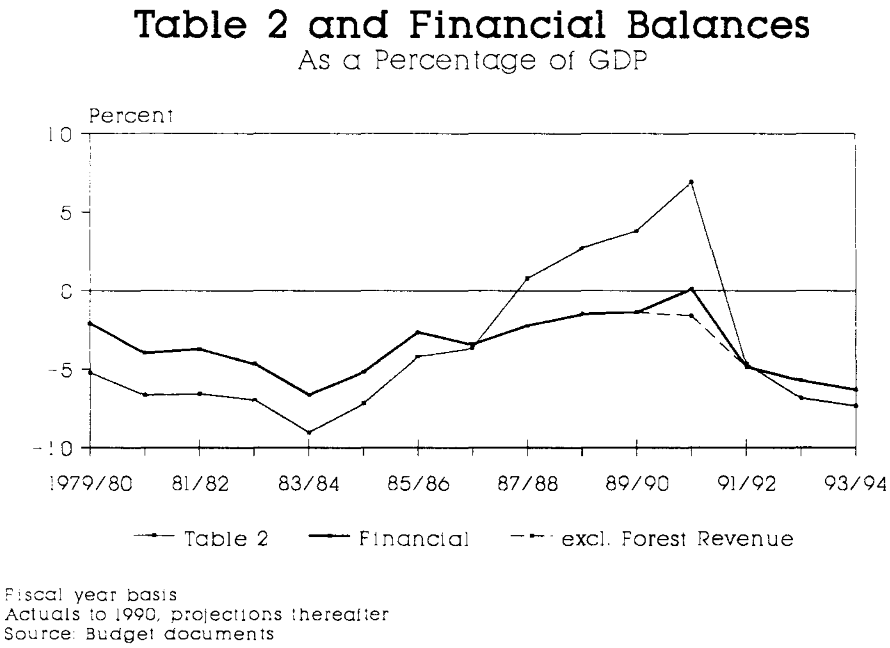
	1991/92		1992/93		1993/94	
	$b	%GDP	$b	%GDP	$b	%GDP
Financial net expenditure[1]	33.4	43.9	34.8	44.0	36.4	44.2
Revenue[1]	29.7	39.0	30.3	38.3	31.3	37.9
Financial balance[2]	-3.7	-4.8	-4.5	-5.7	-5.2	-6.3
Net lending[3]	0.1	0.2	-0.9	-1.1	-0.8	-1.0
Table 2 balance[2]	-3.5	-4.7	-5.4	-6.8	-6.0	-7.3
Net debt[4]	32.8	43.1	38.0	48.0	43.9	53.3

Notes:

1 Excludes net lending.
2 Totals may not add due to rounding.
3 Net lending refers to those transactions which involve the acquisition or sale of financial assets for public policy purposes (i.e., payment or repayment of a loan, or an increase or decrease in equity).
4 Forecasts of net debt are indicative only. No allowance is made for valuation effects or contingent liabilities.

The financial balance differs from the Budget Table 2 balance by excluding net lending transactions.[1] In most cases, the financial balance provides a better measure of the underlying fiscal position.[2] The projected financial balances show deficits of $3.7 billion in 1991/92, $4.5 billion in 1992/93 and $5.2 billion in 1993/94.

Figure 6.1



A deterioration in the underlying fiscal outlook between 1990/91 and 1991/92 of about $1b or 1.4% of GDP was projected in the Budget (after allowing for the one-off effect of forest proceeds in 1990/91). The deterioration in prospect at that stage primarily reflected forecast growth in expenditure on social welfare, the full-year effect of decisions to abolish land taxes and diesel excise and the loss of one-off factors which are boosting revenue in 1990/91.

Since the Budget projections were completed, the forecast 1991/92 financial balance has worsened by a further $1.5 billion (or 1.9% of GDP). Expenditure is projected to be higher than the Budget projections by nearly $2.0 billion (or 2.6% of GDP). The largest increases have been in the projections for social welfare and debt servicing. Social welfare expenditure has increased as a result of changes in assumptions about beneficiary numbers and new policies (such as the GRI Living Alone Allowance) announced in the Budget but not incorporated in the Budget projections. Debt servicing costs are projected to be higher as a result of upward revisions to interest- and exchange-rate projections, and the costs of financing the higher deficit.

1 Net lending refers to those transactions which involve the acquisition or sale of financial assets for public policy purposes (i.e., payment or repayment of a loan, or an increase or decrease in equity).

2 The Budget Table 2 balance is affected by large one-off transactions such as loans or equity sales which distort year-by-year comparisons and which do not affect the Government's net worth. In recent years the financial balance has been used as a proxy for net savings of the Government. However, its usefulness as a measure of savings is reduced in years - such as 1990/91 - when net capital accumulation is significantly different from depreciation.

Tax revenue is projected to fall by nearly $130 million from Budget forecasts as a result of lower expected economic growth. The higher expenditure and lower taxation projections are partially offset by higher projected non-tax revenues.

The Budget Table 2 balance is projected to move back into deficit in 1991/92 with the expected reduction in proceeds from asset sales and loan repayments.

It should be noted that, as is normal at this stage in the Budget cycle, the projections of expenditure are based on departmental estimates of the cost in future years of existing policy. In some instances, departments' interpretation of existing policy, views on the level of capital required to implement existing policy and estimates of the likely movement in the cost of producing their outputs may differ quite significantly from those of the Treasury. These differences are normally resolved as the Budget cycle proceeds.

Apart from this, the projections are subject to a degree of uncertainty, both up and down. They do not make any allowance for policy changes. In addition, the projections are sensitive to changes in underlying economic conditions, such as inflation, interest rates and economic growth. For example, a 2.0% increase in interest rates for 1991/92 and 1992/93 could add around $300 million to debt-service alone, if there are no offsetting changes to exchange rates or other factors. If unemployment was lower by 10,000 people then payments of unemployment benefit would be reduced by around $100 million.

Another way of looking at the fiscal position is to separate out the current and capital components of the fiscal position.[3] Figure 6.2 shows that by 1987/88 the previous very large shortfall between current revenue and expenditure had been brought into balance. Since then an increasing shortfall has been funded by the sale of assets and SOE loan repayments.

Without policy changes, or additional capital revenue, the shortfall will have to be funded by further borrowing. This will increase public-sector debt.

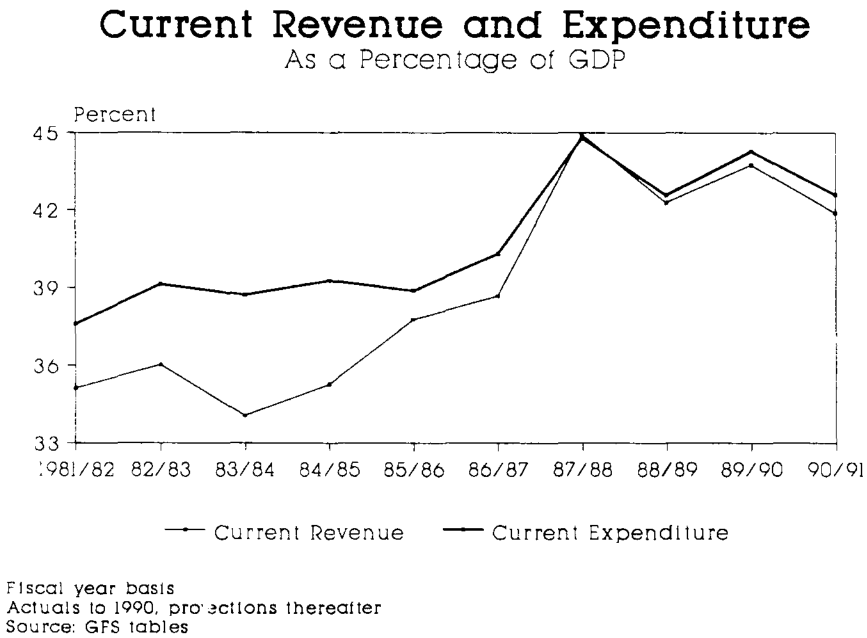
Debt

Any assessment of the fiscal outlook needs to consider changes in the stock of public debt.

There are two measures of public debt: gross public debt and net public debt. Gross public debt measures the direct financial liabilities of the Government. Net public debt also takes into account the extent to which the Government's debt liabilities are offset by fixed income assets such as loans to SOEs and official reserves. It is generally a better measure of the debt burden than gross public debt. In recent years, however, the interpretation of changes in net debt has been affected by the restructuring of the Government's trading activity into State-Owned Enterprises (SOEs). This restructuring has involved the write-off of loans to the Rural Bank and other organisations and creation of new loans to SOEs such as Electricorp. For these reasons it is useful to consider changes in both gross and net debt.

3 Current expenditure on a GFS basis is essentially the sum of operating costs (excluding depreciation), interest payments on debt servicing and transfer payments. Current revenue includes total taxation revenue and non-tax revenue such as property income.

Figure 6.2



Gross public debt increased substantially from 1974/75 onwards, peaking at 79% of GDP at 31 March 1987. The growth in gross public debt up until 1986/87 was primarily the result of large fiscal deficits, the Government's assumption of responsibility for major project and producer-board debt in 1986/87, and adverse exchange rate movements.

Since its peak in 1986/87, gross public debt has been reduced to an estimated 64% of GDP at June 1990. This level will fall further during 1990/91. This decline has been largely the result of the Budget Table 2 surpluses generated since 1987/88, which have included proceeds from asset sales, being used to retire debt. The proceeds of asset sales, either received or due in the current financial year, exceed $9.5 billion. Despite the reduction in debt, gross debt as a proportion of GDP is still high compared with many other OECD countries, as shown in Table 6B.

TABLE 6B - INTERNATIONAL COMPARISON OF GOVERNMENT DEBT (Ratio to GNP or GDP)[1]

	Gross Debt 1984	Gross Debt 1989	Net Debt 1984	Net Debt 1989
Major 7 Countries				
United States	45.2	51.4	24.7	29.8
Japan	68.4	68.0	26.9	14.1
Germany	41.5	42.7	21.6	21.9
France	43.8	47.3	21.1	25.4
Italy	77.1	97.0	74.4	94.3
United Kingdom	54.8	39.6	47.5	32.9
Canada	58.8	69.2	26.1	38.0
Smaller Countries				
Australia	25.1	16.5	n/a	n/a
Austria	47.9	57.8	n/a	n/a
Belgium	118.6	133.0	108.6	122.4
Denmark	67.0	54.9	37.2	23.1
Finland	19.1	15.5	0.7	-2.1
Greece	49.5	75.0	n/a	n/a
Ireland	113.2	125.4	n/a	n/a
Netherlands	66.1	80.1	39.9	57.2
Norway	38.7	41.2	-12.5	-25.6
Spain	41.8	47.3	23.2	29.3
Sweden	67.2	51.7	12.6	0.6
Average of Smaller Countries	55.5	58.1	34.7	37.3
Average of Above Countries	53.5	57.1	30.2	31.0
New Zealand	72.8	64.0	41.4	51.7

1 The figures are from the OECD Economic Outlook, June 1990. Figures for most countries refer to the general government sector (i.e., including state and local government) whereas the New Zealand figures are only for the central government sector. The figures are for calendar years. New Zealand figures are for the March 1985 year and an estimate for the June 1990 year. "n/a" denotes figures not available.

Between the early 1980s and 1986/87, movements in net public debt generally rose in line with gross public debt. However, more recently, net public debt has increased relative to GDP at the same time as gross debt has declined.

There are three main reasons for the divergences between changes in gross and net public debt:

- With the assumption of major-project and producer-board debt the Government has had to increase its own borrowings in order to repay the existing debt associated with those areas. However, repayment did not always occur at the same time as the new loans were raised. In some instances the additional borrowing was held in reserves for a period.

- While the repayment of loans by SOEs since 1987/88 has reduced gross public debt, these repayments did not reduce net debt as they were offset by a decline in the Government's financial assets.

- Since 1987/88 net public debt has been increased by the write-off of loans owed to the Government by state trading enterprises such as the Rural Bank. In the past these assets may have been overvalued, which implies that net public debt may have been understated in earlier years.

Current levels of net public debt are considerably higher than levels prevailing in most other OECD countries. Table 6B shows that the average OECD net public debt as a proportion of GDP was 31% in 1989, compared with an estimated 51.7% for New Zealand at 30 June 1990. New Zealand's net public debt is projected to fall in 1990/91, and then rise substantially over the following three years.

While the fiscal balance measured on a cash, or Budget Table 2 basis, is the major controllable determinant of changes in the level of gross public debt, further off-balance sheet debt could add to measured public debt levels over the next few years. One change which is likely to add to the recorded level of government debt is associated with the transition of the Housing Corporation to departmental status. Its liabilities could add over $2 billion to recorded gross public debt. The precise impact will remain uncertain until the nature of the transactions and their accounting treatment has been determined.

The government faces contingent liabilities in a number of other areas. For instance, guarantees have been extended to organisations such as the Earthquake and War Damage Commission and the National Provident Fund. While difficult to anticipate, there is always the possibility that liabilities such as these could add to recorded public debt levels in future years. Past experience with entities such as the Bank of New Zealand and the Railways Corporation shows that poor performance by organisations which carry either an explicit government guarantee or have government ownership can significantly affect the Government's financial position. Given New Zealand's already-high public debt, the emergence of further liabilities would place an additional strain on the Government's budgetary settings, and reduce the flexibility to adjust policies to changing economic conditions.

In addition, in the next few years the establishment of individual state sector employer superannuation schemes and the possible transfer of existing Government Superannuation Fund (GSF) members to those schemes could see the Government having to fund some current unfunded liabilities of the GSF earlier than would otherwise have been the case. No allowance for this has been built into the current projections.

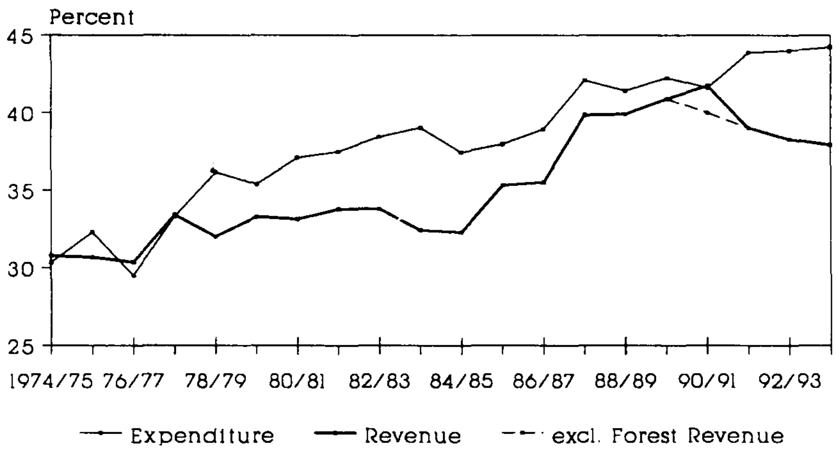
Revenue

New Zealand's government revenue has increased faster relative to GDP than in most other OECD countries. The ratio of government revenue to GDP increased from 30.8% in 1974/75 to about 41% of GDP in 1989/90.
Part of this growth is due to accounting changes which should be excluded when comparing revenue trends over time. For example, the requirement that government departments pay GST increased recorded expenditures and revenues without affecting the underlying fiscal situation. After adjusting for these influences, revenue rose to around 39% of adjusted GDP in 1989/90.

Increases in revenue have largely been achieved by broadening the tax base. New taxes, including GST, have been introduced while exemptions and opportunities for avoidance have been reduced. The payment by SOEs of interest on outstanding loans has also provided significant revenue, but most of these loans have now been paid off. This fact, along with the sale of assets, has reduced non-tax revenue in recent years.

Figure 6.3

Government Expenditure and Revenue
As a Percentage of GDP



Fiscal year basis
Unadjusted expenditure, financial basis
Source: Budget documents

Expenditure

Since the mid-1970s there has been consistent growth in government expenditure. The ratio of government expenditure to GDP on a financial basis rose from 28.4% in 1974/75 to over 42% in 1989/90. After adjusting for fiscally neutral effects, such as the GST paid by government departments, this figure was still around 40% of adjusted GDP.

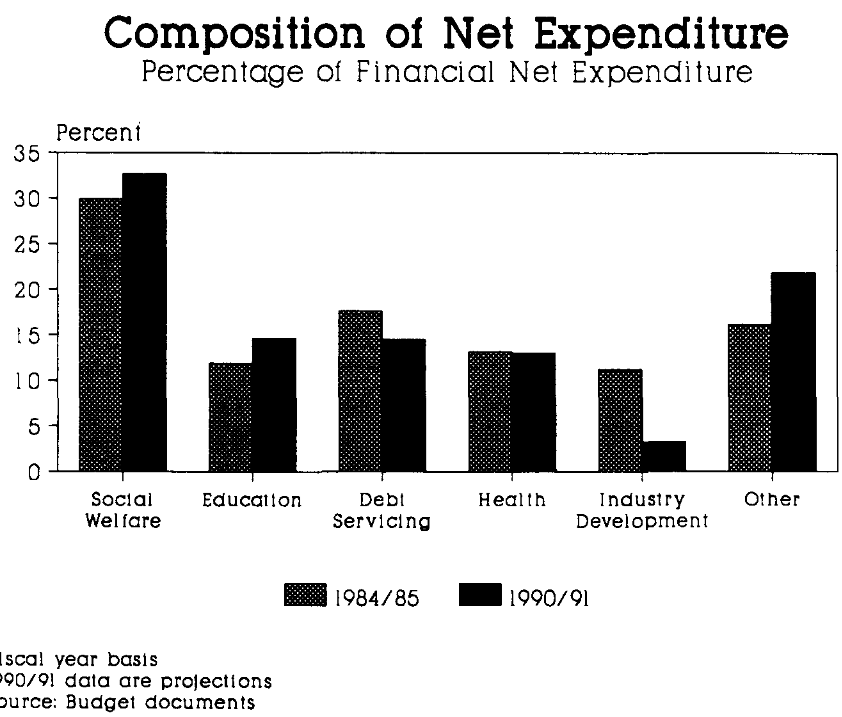
In the period up until 1984/85, expenditure trends were dominated by the introduction of National Superannuation (now Guaranteed Retirement Income) and the growth in debt-servicing costs.

Spending on health as a percent of GDP was at about the same level in 1984/85 as a decade earlier while spending on education actually fell relative to GDP over that period. Spending in both areas was affected by the wage and price freeze. In addition, student numbers began to fall from the late 1970s onwards, which also contributed to slower growth in education spending.

Spending on assistance to agriculture rose sharply in the early 1980s.

Since 1984/85, significant changes have been made to the composition of government expenditure with funds directed away from industry development and debt servicing towards social welfare and education.

Figure 6.4



A major factor in the growth in social welfare expenditure has been the increase in unemployment which, although rising almost continuously in the period since the mid-1970s, has increased sharply in recent years. Payments to sole parents have increased, again due to rising numbers of beneficiaries. Associated with the rise in beneficiary numbers has been an increase in the cost of social welfare administration and social work.

Spending on health and education has risen as a percent of GDP since 1984/85, partly as a result of the substantial pay increases which followed the end of the price and wage freeze. The rise in spending on education has also reflected increased emphasis on training and tertiary education, pre-school education and the desire to improve teacher-pupil ratios.

Other areas to show significant increases since 1984/85 include spending on justice, the Government Superannuation Fund subsidy and the administration of the tax system.

Debt-servicing costs have risen for much of the period since the mid-1970s. Although debt servicing has declined in recent years due to the asset sales programme, at a forecast level of $4.3 billion in 1990/91 it still represents 6.0% of GDP compared to 2.3% of GDP in 1974/75. This rise in debt-servicing costs mainly reflects the effects of large deficits, debt, interest rate and exchange rate changes; and recognition by the Government of additional liabilities.

THE NATURE OF THE FISCAL PROBLEM

Deficits

In the present economic situation, the forecast deterioration in New Zealand's financial deficit is likely to worsen the situation already facing the economy and undermine overall policy effectiveness for three main reasons:

- The financial balance and monetary policy are the two policy indicators most used by the private sector to assess the direction and credibility of economic policy. New Zealand's history over the last two decades of rising debt and high inflation makes us more exposed to shifts in investor confidence about our future economic performance. A financial deficit of the magnitude projected would signal that the Government was unable to achieve fiscal discipline. Financial markets would question the Government's commitment to lower inflation. As a result investors could be expected to seek compensation for increased inflation risk through higher interest rates.

- In order to finance the deficit in a non-inflationary manner, the Government would have to increase its domestic debt sales programme. This would put upward pressure on interest rates, and, provided confidence in the Government's anti-inflation commitment was not eroded, the exchange rate as well. A rising exchange rate could be expected to reduce the profitability of exporters and those competing with imports, and would discourage producers from switching resources into these areas.

- Large deficits combined with the implied increase in debt levels, are likely to increase the economy's exposure to adverse interest- and exchange-rate movements and shocks in the international economy. Past failures to solve fiscal problems have increased New Zealand's exposure to adverse events by increasing debt levels.

It is possible that an increase in the financial deficit may increase demand and thus output growth in the short term. Fiscal expansions were used in the 1970s and 1980s to accelerate domestic demand, although their effects on output and employment tended to be variable and unpredictable. Over time the continued use of fiscal policy in this manner resulted in weaker output and employment responses. Producers regarded the stimulus to demand as likely to be short-lived, and responded in part by raising prices and increasing overtime, rather than meeting all of the growth in demand by producing more and employing extra labour.

In the present environment a larger financial deficit would lead, at most, to only a small increase in output and employment. The likely rise in interest rates and the exchange rate could be expected to reduce any initial stimulus but, perhaps more importantly, the private sector would also question the intent of Government policies and whether they could be sustained. Fragile business confidence could be further undermined, with a resulting reluctance to invest.

Continued large financial deficits are harmful to economic performance. Deficits are likely to reduce the overall level of national savings, and so demands on foreign savings will increase. As a result, a deterioration in the financial deficit could be expected to put further pressure on New Zealand's current account balance and increase external indebtedness. The interest rate effects associated with persistent deficits would create a bias against investment, thereby impeding the long-run growth prospects of the economy.

The Growth in Public Debt

The projected deterioration in the deficit would continue the growth in public debt over the 1970s and 1980s. The interaction between deficits and levels of debt raises further concerns about the sustainability of current fiscal policy. New Zealand's net debt is already relatively high by international standards. On the basis of the current projections debt relative to GDP will continue to edge up over the forecast period. Given the continuing fiscal pressures on any government, there is a real risk that, without policy decisions to reduce the deficit, the debt-to-GDP ratio would rise more rapidly.

An increase in debt-to-GDP ratios could not be sustained indefinitely. Ultimately an adjustment could be forced on the Government either by a break in market confidence or through resistance to rising tax burdens. If this were to happen, major cuts to government services and reductions in real incomes would have to occur very rapidly. Early fiscal adjustment lessens this risk of subsequently being forced into adjustment in a way far more disruptive to the economy.

Moreover, there are strong grounds for seeking to reduce current debt levels. High debt levels are of policy concern for three reasons:

- There are important issues about inter-generational equity. Borrowing means that the tax increases required to meet expenditure are deferred onto future generations. This need not be of concern if the debt finances investment activities that yield a sufficiently high return to compensate future generations for the borrowing undertaken. However, much of the debt incurred in the past was used to finance current consumption or investment which generated low returns to the nation. Currently, the size of the deficit exceeds the level of net government investment. This means that the increase in debt is not being matched by an increase in assets, and is instead being used for consumption.

- The debt-servicing costs caused by rising net public debt feed back into government spending and absorb an increasing proportion of tax revenues. This spiralling effect is exacerbated if, as is likely, interest rates are increasing at the same time.

- If financial markets consider that high and rising debt gives the Government an incentive to allow inflation to reduce the value of the debt, that will put upward pressure on interest rates.

Expenditure and Revenue Trends

The discussion on expenditure highlighted its growth as a percentage of GDP. This trend in expenditure lies at the heart of the deficit problem of the last two decades.

It is not possible to attribute the trend in expenditure to one particular cause or set of Government decisions. Increasing community expectations, the effects of economic restructuring and the cost of past borrowing have all played a part.

However, there are some lessons from this experience. Our recent history demonstrates that ongoing deficits and low economic growth can generate considerable additional pressure on fiscal policy through rising debt-servicing costs, increased benefit payments and slow growth in tax revenues.

In addition, the upward trend in expenditure shows that the expenditure process as a whole has been unable to accommodate increased expenditure in higher priority areas within a fixed overall level of spending. Where new expenditure commitments have been incurred they have frequently been seen as additional to existing policies.

The result has been rising tax burdens within the economy. Such trends in revenue undermine certainty about future tax rates and reduce confidence about the future returns to investment, saving and work effort. Given our recent history, the current prospects of larger fiscal deficits, coupled with the absence of adequate expenditure controls, is likely to signal continuing increases in tax burdens.

TACKLING THE FISCAL PROBLEM

Achieving significant and early reductions in the financial deficit should be a major Government priority. Beyond that, financial surpluses would represent a significant break with the persistent and often chronic deficits experienced since the early 1970s. Surpluses are necessary to reduce public debt. They would leave the Government well placed to pursue a policy which on average achieved balanced budgets in the medium term.

However, the way in which the fiscal deficit is reduced is also very important. Eliminating the gap between expenditure and revenue by action on the expenditure side is likely to be far more conducive to sustained economic growth than taxation increases.

An expenditure process which achieves desired aggregate expenditure outcomes while also delivering the Government's major policy goals should be a key objective. Tackling not only levels of expenditure but also institutional structures and the delivery mechanisms for achieving particular policy goals is likely to assist in achieving this objective by enabling better quality services and lower costs. Once some progress is made in this direction, the process is likely to develop a momentum of its own to the extent that lower expenditure and deficits reduce the growth in debt-servicing costs and ultimately create the scope for lower tax burdens.

Even with higher rates of economic growth, the financial deficit will remain a problem. For instance, many of the factors underlying the projected increase in the deficit relate to expenditure commitments or behavioural patterns which are not primarily driven by rates of economic growth.

Expenditure Reductions

The fiscal problem will not be fully resolved until expenditure growth is addressed. In addition, given the costs associated with raising taxes through reduced economic efficiency, it is appropriate first to consider whether existing expenditures are achieving value for money before contemplating adjustments to taxes.

It is desirable, however, that any spending cuts not jeopardise the attainment of the key public-sector outputs and the outcomes being sought. Recent financial management reforms will, as discussed in Chapter 7, provide an opportunity both to improve the quality of government spending and to relieve some of the pressures for further spending.

Spending on social welfare, health, education and defence accounts for nearly 80% of total expenditure (excluding debt servicing). While there is scope for savings elsewhere, significant expenditure savings will inevitably need to be found in these areas.

The scope for efficiencies in health and education is limited under the present mechanisms for funding and delivery of these services. Attempts to cut expenditure in these areas under present institutional structures could result in substantial reductions in the quality and level of services, rather than result in greater efficiencies and lower costs.

To maintain and ultimately to improve the quality of social services, while still tackling the fiscal problem, it is important to review not just levels of spending, but the wider aspects of the Government's expenditure and regulatory activities. This could involve examining the scope for greater efficiency gains through alternative forms of delivery of social services; an assessment of the costs and benefits of greater targeting of assistance; and reviews of the mechanisms for funding the supply of services. Policy developments along these lines have the potential to yield significant improvements in the quality of services and generate expenditure savings at the same time.

Complex problems can arise in the interplay of benefit and tax structures, particularly in the labour market. The tax and benefit system can result in high effective marginal tax rates for a large group of workers. These reduce the incentive to work. This is an argument against increases in tax rates. Levels of benefit assistance in relation to average earnings are high by overseas standards and there is scope for reviewing them and tightening eligibility criteria. For example, the Australian Government has been able to generate significant improvements in its fiscal position through controlling benefit eligibility and tightening benefit administration.

Increasing Revenue

Further increases in tax burdens will not assist economic performance. However, the current fiscal outlook is such that, if the Government is unable to achieve sufficient reductions in spending, it will need to consider increasing sources of revenue. In recent years the proceeds of sales of state-owned assets have been used in part to reduce levels of debt, but have also helped to finance government spending. There are limits to this process, and asset sales cannot be seen as a solution to the current fiscal problem.

Alternative means of raising revenue are to raise tax rates or increase the tax base.

The quickest option for obtaining greater tax revenue would be to raise rates of tax. However, each of the possible options would create some problems. As outlined in Chapter 11, the costs to the economy of raising additional tax revenue normally exceed the amount of revenue raised by a significant amount. Increasing GST would add to the rate of inflation if the increase were passed through into wage and salary increases. It would also put the broad base of GST at risk, through pressures for exemption. Raising rates of personal income tax alone would place a wedge between the personal rate of income tax and the company rate, encouraging tax avoidance and evasion. Increasing the company tax rate could discourage investment within New Zealand, particularly as a number of other OECD countries are currently lowering corporate taxes.

Table 6C indicates the amount of revenue that could be secured by raising tax rates by 1 percentage point:

TABLE 6C - ESTIMATED REVENUE EFFECTS

Tax rate changed by 1 percentage point	Change in Tax Assessed $m
Top personal tax rate (currently 33%)	80
Bottom personal tax rate (currently 24%)	415
Company tax rate (currently 33%)	80
Fringe benefit tax rate (currently 49% of the net benefit)	9
GST tax rate (currently 12.5%)	430

The other, more desirable, means of raising revenue is to extend the tax base. However policy development and legislative programmes mean that such base broadening is often slow to implement, with even crash programmes taking up to 18 months to generate significant revenue.

The Speed of Fiscal Consolidation

A programme of deficit reduction and a move back into financial surpluses could take a number of years. It is very important, however, that the Government's full commitment to this programme is signalled by early and measurable progress. The credibility of fiscal policy will have to be earned by results, and cannot be established simply by announcements of plans for the medium term. It is also important that the decisions taken can be sustained, and will put into reverse the forces that have been driving expenditure upwards over the past two decades.

There are no simple rules to specify the appropriate speed to move into surplus. Inevitably this will involve judgements about the range of policy choices available and the lags inherent in implementing policy, and will involve balancing the need for expenditure savings against the need to take a thorough approach to reforming government expenditure. Poorly designed expenditure-reducing policies are unlikely to offer savings on a permanent basis.

Assessing the most appropriate pace of fiscal adjustment also involves balancing macroeconomic risks. In the current economic context, moving all the way to financial balance in the 1991/92 year entails a substantial risk of reducing economic growth in the short run. On the other hand, failure to exert adequate fiscal discipline would cause doubts about both the Government's policy objectives and its ability to meet them. The resulting increase in uncertainty could increase volatility in exchange rate and interest rates.

Therefore an optimal rate of reduction in the fiscal deficit will do a number of things. It will:

- be fast enough to gain early credibility so as to achieve a marked reduction in the pressures on inflation objectives, on activity in the exposed sectors of the economy and on investor confidence

- be fast enough to reduce significantly the exposure of the economy to shocks and future fiscal problems by slowing the build up in debt

- not be so quick as to require policies which are poorly designed or which jeopardise the achievement of longer term goals

- focus on achieving expenditure reductions rather than tax increases, and on the longer term objective of achieving fiscal surpluses.

EXPENDITURE REFORM AND BUDGET PROCESSES

Key Objectives

Successful Budget decisions result in spending which:

- is consistent with overall fiscal strategy
- is concentrated where it has the greatest value
- is based on a well developed understanding of the rationale and likely impact of decisions, so that they are less likely to be reversed in the face of adverse reaction to them.

A successful process should also aim to avoid unplanned expenditure growth during the year.

Achieving these Objectives

Effective decision-making processes involve a number of dimensions:

- Initially there need to be strategic decisions about total levels of expenditure. These decisions need to have regard to the state of the economy, the pressures facing the economy and the forces driving expenditure.
- Areas of large expenditure involve complicated policy issues. In these areas, the full range of policy instruments available to the Government needs to be considered, beyond just those of expenditure. The issues do not easily lend themselves to effective consideration within the confines of producing the next Budget. They often need to be managed as separate projects.
- Fiscal policy involves a complex interaction between technical and political issues. Every government expenditure policy, no matter how ill-conceived, has a pressure group ready to claim that its benefits are in the national interest. Decision-making processes need to take full account of this.

The most important ingredient in successfully implementing a fiscal strategy is to have a strong commitment to the strategy and to concentrating spending on the highest priorities. If the strategy is to be applied consistently to all the areas of government, it needs to be understood by all Ministers and have the active support of the Prime Minister and other senior Ministers.

Strategic Approach

A key to better choices about government spending is to adopt a strategic approach. A clear view of the desired fiscal position and expenditure priorities at the start of the Budget process is essential if individual Budget decisions are to be mutually supporting and withstand spending pressures. The strategy would need to identify areas from which major expenditure reductions could be expected, as well as those which the Government wishes to accord a higher priority.

In formulating its approach to fiscal policy, the Government needs to be very much aware of the tight resource constraint it faces. It also needs to recognise that fiscal management is always vulnerable to unforeseen developments. The Government should adopt an approach that minimises readily identifiable risks. In particular, it is a risky approach for spending to anticipate higher revenue, or for the Government to commit itself to ongoing programmes funded by one-off revenue gains.

Published Targets

In recent years, a number of OECD countries, including Australia and the United Kingdom, have found public commitment to high-level fiscal targets to be a valuable tool in securing fiscal discipline and stability.

Published targets allow public assessment of the overall success of the Government in achieving its objectives. Such a public commitment, if credible, can boost private sector confidence.

However, credibility is likely to result only over time as the Government establishes a reputation for reaching its objectives. In addition, targets are likely to be more effective where the reputation of the Government as a whole is identified with the target.

While high level targets can be potentially useful there are also disadvantages. For instance, too high a degree of precision can create policy inflexibility in the face of changing circumstances. Being publicly locked into achieving a particular policy goal may make it more difficult to implement policy changes which, while inconsistent with a given target, are nevertheless highly desirable on other grounds. In addition, policy can become driven by the need to meet a short term target with little thought given to the longer term consequences.

These problems suggest that it may be better not to be overly precise in formulating a target and to avoid relying too heavily on any one indicator. General targets such as reducing deficits and debt, and slowing the growth in expenditure, backed up by information on how these are to be achieved, are likely to be more useful.

Managing Decision-making

As a result of the Budget strategy, a number of complex issues may need detailed and lengthy analysis to ensure that spending proposals are based on a good understanding of their likely effects, and reflect Government priorities.

However, the time constraints of the Budget cycle are not conducive to the extended consideration of policy issues. In some instances it may be useful to commence in-depth reviews before the Budget cycle to enable final decisions to be made in preparing the Budget. The terms of reference of these reviews should ensure that the task of reducing fiscal costs is not forgotten. In particular, the Government has a wider range of policy instruments available to it than just expenditure policy (e.g., the ability to regulate or deregulate). The aim should be to avoid regarding expenditure as the only means available for the Government to achieve its objectives. Almost inevitably, this means that the Minister of Finance needs to become quite familiar with policy issues that are the primary responsibility of individual spending Ministers.

Reviews will be made easier by the change in focus of Budget decision-making as a result of financial management reforms. As discussed in Chapter 7, Ministers are now better informed of the cost and quantity of individual outputs, and how these outputs relate to desired policy outcomes. Better information is also now available on the financial performance of departments.

Considerable room exists to use the improved information provided by these reforms more effectively to clarify expenditure priorities and, in particular, to identify low-quality spending. Ways to use it include a greater focus on the relationship between outputs and policy outcomes, and considering together outputs produced by a number of different departments that contribute to the same policy outcome. In addition, it should be possible to make better use of the potential for increased accountability of Chief Executives under the State Sector Act.

Outside of the priority areas where there is substantial spending and where in-depth reviews are needed, it is clear that the scrutiny will be less intense even if all the issues mentioned in the previous paragraph are addressed. There is likely to be value in subjecting these more routine areas of spending to occasional detailed review.

Assessing Spending Proposals

When Ministers consider the proposals of one of their colleagues, they often know little about the proposal or the area of policy involved and have limited time to investigate it. One way to partially redress this imbalance is to be quite rigorous about the criteria which spending proposals must satisfy. This is made easier where the Government has identified its priority goals. Then each Minister could be required to explain how his/her proposals contribute to these goals. The strength of that contribution would help other Ministers decide whether the particular spending proposal had priority over other potential uses for the same resources.

Preventing 'Expenditure Creep"

New policies approved during the year are one of the main sources of "expenditure creep". For instance, between the 1989 and 1990 Budgets, policy decisions increased the level of government expenditure in 1990/91 by $327 million (or 1% of net expenditure) even after taking account of decisions which produced savings. Too frequently, new policy is agreed without offsetting savings or without searching for alternative ways of achieving the policy objective. The outcome is continued upward pressure on spending rather than a reallocation of existing funds to new spending priorities.

The problem is compounded if decisions are taken outside the formal Budget process and by a number of Cabinet Committees. Similarly, the Supplementary Estimates have become a mechanism for consideration and funding of new policy, adding to expenditure pressures. This can offset many of the gains in reducing expenditure achieved in the formal Budget process, and through the year leads to decisions being taken in isolation from consideration of the fiscal position.

Significant improvement could be realised from a more structured approach. Expenditure decisions might be confined to the formal Budget process or concentrated within a single Cabinet Committee with strategic responsibility for fiscal policy. If it is seen as desirable for a number of Cabinet Committees to have authority to approve expenditure, this authority might be delegated subject to compensating savings being identified for each new spending proposal.

Past approaches to new policy have not been particularly successful in containing spending pressure. A decision to not allow any new policy in a given Budget year, while superficially attractive in a period of fiscal stringency, may not be sustainable. New-policy pressures tend to build up at a late stage in the Budget process. The result is serious risk for both the fiscal position and the quality of expenditure. Similarly, a separate "new-policy round" tends to stimulate significant spending pressure artificially, gives rise to considerable activity to invent new policy, and normally results in total new-policy expenditure in excess of the agreed allocation.

A more useful approach would be to consider major new policy as part of the strategic review of spending priorities at the outset of the Budget process. In essence, major new-policy initiatives represent a change to expenditure priorities. These initiatives could be evaluated in detail along with the review of existing expenditure. Minor new policy might be dealt with on the basis of Ministers identifying compensating savings within their portfolios.

Institutional Arrangements for Decision-making

International experience suggests that a variety of institutional arrangements can be successful in improving the coherence and quality of Government's spending decisions. The most useful arrangements will, in part, depend on the personalities and operational style of relevant Ministers and the Government generally. While a well designed process is important in contributing to fiscal discipline, it cannot, however, compensate for a lack of overall Government commitment to the fiscal strategy.

A Cabinet Committee

In recent years a committee arrangement has been used to develop final expenditure proposals for approval by the full Cabinet. In early 1989, this was formalised in the Cabinet Expenditure Review Committee. The perceived advantage of this arrangement is the potential to assist fiscal discipline by key Ministers developing a commitment to the Budget process and a better understanding of the implications of particular decisions for fiscal outcomes. Experience here and in Australia (where this model has been successful in controlling expenditure pressures) suggests that these benefits will be realised only where:

- the Committee is involved in strategic consideration of fiscal policy and of expenditure priorities
- members are committed to these outcomes and the operations of the Committee
- the Committee involves senior Ministers who are prepared to take on a substantial workload.

The Minister of Finance

Alternatively, responsibility for developing Budget proposals might rest primarily with the Minister of Finance. Factors crucial to the success of this type of Budget process appear to be the status of the Minister, Prime Ministerial support, the strength of the Government's commitment to a given fiscal outcome and general agreement within the Cabinet as to policy priorities. It has been successfully applied in the United Kingdom, with much of the detail of the Budget dealt with at the officials' level, and the major issues resolved in bilateral negotiations between a Treasury Minister and the responsible spending Minister. A committee is used only as a last resort. Discipline over individual spending Ministers and their departments derives in large part from the Prime Minister's public support of expenditure targets at the start of each new Budget process and the backing that implies for rigorous scrutiny of spending proposals. Strategic thinking on spending priorities is undertaken outside the formal Budget process, usually within the context of policy reviews.

A mix of institutional arrangements may well be appropriate, varying with the stage in the budget cycle and the nature of the decisions being made. For instance, decisions on government priorities and fiscal policy may be best worked through by a committee. On the other hand, detailed review of departmental outputs may be more appropriately carried out by the Finance Minister and the Vote Minister, with issues returning to a committee or Cabinet for final confirmation.

Regardless of the process ultimately adopted, it is important that it is well understood and that it is adhered to so that all decisions are integrated into the overall strategy.

CONCLUSION

The current fiscal outlook is for a substantial and ongoing increase in the Government's financial and cash deficits. This comes at the end of two decades which have seen sharp rises in the ratios of debt, expenditure and revenue to GDP.

Financial deficits of the magnitude projected would seriously worsen the balance in economic policy. The resulting interest rate and exchange rate effects would impede investment and hamper the exposed sectors of the economy. Such deficits risk compounding the problems implied by current debt levels and undermine confidence in the Government's inflation commitment and ability to control taxation levels. Achieving financial surpluses should be a major Government priority.

However, in tackling the fiscal problem the Government should be careful to address its root cause. Expenditure processes over the years have delivered a rising level of expenditure and, as a result, increasing tax burdens and debt levels. Successful resolution of the fiscal problem requires the implementation of comprehensive expenditure reform. Such reform should produce ongoing reductions in government expenditure while minimising the impact on socially desirable outcomes. A strategic approach to decision making coupled with a total Government commitment to that strategy is essential to this process.